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Reporting Income Under "Ledger" Contracts

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Reporting Income Under "Ledger" Contracts

— by Neil E. Harl*

Although ledger contracts for marketing hogs have been around for nearly a decade,[1] audit activity has picked up in recent months with taxpayers questioned as to how income under the contracts was reported during the period of extremely low live hog prices in 1998-99 when hog prices dropped to as low as eight cents per pound.

What are "ledger" contracts

Ledger contracts were developed as a risk-sharing arrangement between a producer and a livestock packer under which the parties agreed that the packer would pay a specified amount per pound of live hogs (such as 38 cents per pound) regardless of the actual cash price. If the specified price was less than the market price, a balance would build up on the packer's ledger in favor of the producer. When the cash price was less than the specified price, the producer would still receive the specified price and the ledger balance on the packer's books would be reduced accordingly. If the specified price was set at or near the long-term average price for live hogs, the ledger balance would fluctuate as the market price oscillates above and below the long-term average price. With such a contract in hand, a producer, especially a marginal producer financially, would be more likely to obtain necessary funding for production facilities.

The extended downturn in live hog prices in 1998-99 produced large, sustained negative balances in the ledger account.[2] Among the obvious questions raised by such large negative balances were-(1) what is the packer's position relative to the producer's lender; (2) how is the ledger account handled on the producer's balance sheet; (3) what are the consequences if the packer (or producer) declares bankruptcy, terminates the business or is sold; and (4) how does the producer report payments in the face of a large sustained negative balance in the ledger account?

In this article, the principal focus is on how a producer reports payments for live hogs during a period of large, sustained negative balances.

Income tax treatment of payments for live hogs

The income tax aspects relate to two distinct reporting problems—(1) how payments for live hogs should be reported and (2) how payments at the end of a contract are to be reported.

First, it should be noted that amounts actually paid for live hogs should be reported as income as the payments are received.[3] As the Internal Revenue Code clearly states,

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"Except as otherwise provided . . . gross income means all income from whatever source derived, including (but not limited to) . . . gross income derived from business . . .."[4]

Example 1:

A taxpayer has a ledger contract with a packing plant that sets the specified contract price at 38 cents per pound of live hogs. The taxpayer delivers 400 hogs weighing 100,000 pounds at a time when the market price is 43 cents per pound. The taxpayer is paid 100,000 x $.38 = $38,000 and the ledger account balance is credited with 100,000 x ($.43 - .38) = $5,000. The taxpayer reports ordinary income of $38,000.

If the market price for hogs is below the specified contract price when the live hogs are delivered, the producer is paid the contract price (38 cents per pound in this example) and the difference between the specified contract price and the market price is subtracted from the ledger account.

Example 2:

The taxpayer in Example 1 delivered 100,000 pounds of live hogs when the market price is 35 cents per pound. The taxpayer is paid 100,000 x $.38 = $38,000 and 100,000 x ($.38 - .35) = $3,000 is subtracted from the ledger account. The taxpayer would report ordinary income of $38,000.

Inasmuch as taxpayers do not have the right to collect a positive balance in the multi-year ledger account or have the duty to pay a negative balance in the ledger account until the end of the contract, the taxpayer is neither required nor allowed to report the ledger account balances until the end of the contract.

The income tax consequences of the ledger contract are essentially the same whether the producer uses the cash method of accounting or the accrual method of accounting. The duty to report a positive ledger account balance or a negative ledger balance does not arise until the end of the contract and is dependent upon the market price for live hogs until the end of the contract. Therefore, the economic performance rules do not allow (or require) an accrual basis taxpayer to recognize a loss or a gain until the taxable year in which the contract ends.[5]

At the end of the contract, positive balances paid to the producer are reportable as ordinary income; negative balances reduce income by the amount of the payment and should be reported as a negative amount on Schedule F.

Are payments in excess of market price a loan?

The argument has been made that payments in excess of the market price for live hogs could be treated as loans. That would appear to be possible only if the amount in question is a bona fide loan. The authority which has emerged in recent decades for the taxation of advances on commodity sales sold with deferred payment provides useful guidance on when a payment is a bona fide loan.[6] Of course, a practice of reporting amounts by which the specified price exceeds the market price should involve reporting the excess of the market price as income over the specified price in years in which that is the case.

Fundamentally, however, treating the amounts as loans is only possible where it can be established that the amounts are bona fide loans. That is difficult to establish, if not impossible, when the contract does not characterize the amounts as loans as has generally been the case with ledger contracts for hogs.

FOOTNOTES

1 See Harl, Neil E. and John Lawrence, "Long-term Marketing Contracts with Packers: A Journey Through the Downside," 35 *Iowa Pork Producer* No. 9 (Sept. 1998). See also Harl, Neil E., "Hog Contract Losses," *Ag Decision Maker*, Iowa State University Extension Service, February, 1999.

2 See Harl and Lawrence, note 1 *supra*.

3 I.R.C. § 61(a).

4 I.R.C. § 61(a)(2). See Treas. Reg. § 1.61-1(a): "Gross income includes income realized in any form, whether in money, property or services."

5 Rev. Rul. 72-34, 1972-1 C.B. 132. See United States v. General Dynamics Corp., 481 U.S. 239 (1987) (accrual method taxpayer; "all-events" test). See also I.R.C. § 461(h).

6 Fleming v. Comm'r, T.C. Memo. 1966-251 (receipt of advances against indefinite future payments did not have to be reported in year of receipt where advances were intended to be loans); Rutland v. Comm'r, T.C. Memo. 1977-8. Compare Rev. Rul. 69-358, 1969-1 C.B. 139 (amounts received under fruit purchase contracts includible in income upon receipt regardless of whether sale price fixed at time contract signed, at time fruit picked or at time fruit delivered; sellers on accrual accounting include partial payments in income in year received and remainder in income in year price determined when price not determined until fruit picked or fruit delivered); Rev. Rul. 69-359, 1969-1 C.B. 140 (part of price (determined at time of delivery) received at harvest and remainder when fruit resold by purchaser; amount received at harvest represented part of sale price not loan and is reportable that year as income).